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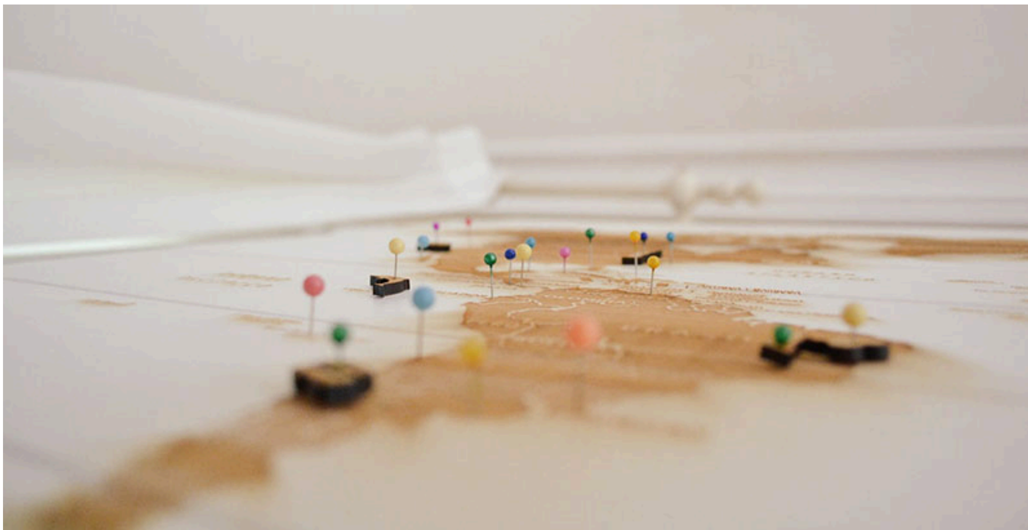
BILBoard December 2018 – Getting reacquainted with fundamentals



After a Goldilocks 2017 when, economically speaking, everything was just right, 2018 was the year when Goldilocks finally met the three bears and things got pretty challenging. Volatility made a comeback, politics and trade tensions took centre stage and market participants readjusted their views and positioning in both equity and bond markets.

Throughout the turbulence, we have maintained a focus on fundamentals, which paint a picture of slowing growth, but not contraction. Of course, this merits tempered positivity, but investors, especially in equities, seem to have over-extrapolated the slowdown, positioning themselves as if we were in the midst of an economic downturn. As investment strategist Ed Yardeni commented, "You had a bear market in the P/E multiple, but a bull market in earnings." Certainly, Purchasing Managers' Indices (PMIs) have come down from stellar levels, but they still sit comfortably above 50 in most major economies – indicating further expansion. The investment committee believes that, in 2019, equity investors will bring their views back into sync with the true economic picture, especially in the US.

So where are we in the US cycle? Growth for next year is projected to be a sturdy 2.6%, with the risk of economic overheating subsiding substantially. The US is not exposed to the same risk factors as Europe and emerging markets (EM), with much of its economic strength coming from

within. US consumers continue to show a high propensity to spend and all components of consumer spending have accelerated by around 4%. Talk of recession is, to us, unwarranted, especially given that real interest rates are still at around zero: we have never seen a contraction with real rates below 1.8%. With inflation rising gradually, as opposed to shooting upwards, we believe the US economy has the strength to prevail. This places us in a "slowing down" phase of the cycle – in which equities normally have a good run. A Fed misstep could derail the outlook, but, for the moment, Jerome Powell is proving to be pragmatic and data-driven. The market consensus is that there will be one more hike in December, and one in 2019, before a pause.

There is a noted desynchronization in growth between the US and the eurozone. The latter seems to have fallen by the wayside with the political risk that peppers the continent – Brexit, Italy's budget drama, the gilets jaunes in France and the threat of populism (which could hit a climax with the European elections in May) – overshadowing the economic outlook. Whatever happens, the ECB will end its QE programme this year, but the big question is how the proceeds will be reinvested and whether the ECB will roll out a new TLTRO scheme.

EMs are a mixed bag. In China, the growth rate is normalizing, demand for imports has come down and trade tensions pose a real risk. That said, the government is funnelling stimulus into the economy, making an imminent crisis unlikely. Nonetheless, the slowdown will affect neighbouring EMs for which China is a huge export market. EMs that are more aligned with the US market, like those in Latin America, should enjoy a modest rebound in 2019, led by Brazil, in the wake of its economic reforms.

Equities

Our macro playbook goes hand-in-hand with our equity strategy, which is centred on the US, positive on EM, neutral on Japan and reluctant on Europe. US equities continue to outshine their counterparts. Consensus estimates for earnings growth of 9% and sales growth of 6% suggest that there is still juice left in the orange to be had next year. With a P/E ratio around 16, the US is more expensive than other regions, though we think this is for good reason.

Normally, at this stage of the cycle when growth is cooling, we start to see growth, quality and momentum stocks outperform and we have therefore embedded such styles into our individual stock selection. In terms of sectors, we maintain a preference for energy. The consensus foresees a rebound in oil prices in 2019 (to around USD 71) and forward EPS estimates suggest energy will outperform. The materials sector also has attractive EPS guidance whilst boasting a free cash flow yield of 8% and a dividend yield of 5%. Materials are also a natural hedge against potential inflation repricing. Technology, which fell from grace in the latter half of 2018, still looks attractive to us. EPS is growing nicely, and the correction has resulted in more compelling valuations. This sector looks set to receive a boost from an onslaught of buybacks in the new year.

In the EM space, both Brazil and Russia have started to outperform, with PMIs sloping upwards. The consensus view predicts EPS growth of 10% and sales growth of 7%. Therefore, it is hardly surprising that fund flows into EM have accelerated recently. EM, as a group, now outperforms developed markets whilst China is outperforming the broader EM index and the US. With a nuanced selection across specific countries, investors can really tap the opportunities that EMs offer.

Fixed income

The fixed income space is becoming something of a minefield with most bonds in a precarious position as central banks remove the support that has artificially suppressed yields. As yields are expected to grind upwards, government bonds, at first glance, are not attractive at all. But whilst they lack appeal in terms of expected returns, they compensate with the added benefits of downside protection and diversification in a downturn. We do not expect smooth sailing in 2019 and therefore take comfort in adding moderate exposure to this class in our more risk-averse risk profiles.

In risk profiles where we have higher equity exposure, we have less cyclical fixed income assets in order to ensure sufficient diversification. In those profiles where we are still overweight on corporate investment grade (IG) bonds, we give preference to those at the higher end of the quality scale (with a higher credit rating) and to short duration.

We dislike high yield across the board. EM debt could start to look attractive if the Fed pauses its hiking cycle, in turn giving momentum to local currencies. However, for the time being, we believe it is premature to enter this asset class.

As the renowned investor Benjamin Graham once said, “In the short run, the market is a voting machine but in the long run, it is a weighing machine.” In 2019, we expect that investors will start to weigh up the sound fundamentals that are still in place, which permit a risk-on strategy, balanced with some safer assets for ballast during volatile episodes.

Strategic Asset Allocation

12/12/2018		DEFENSIVE		LOW		MEDIUM		HIGH	
		STANCE	CHANGE	STANCE	CHANGE	STANCE	CHANGE	STANCE	CHANGE
GLOBAL ALLOCATION	EQUITIES	🟡	➡	🟢	➡	🟢	➡	🟢	➡
	BONDS	🟡	➡	🔴	➡	🔴	➡	🔴	➡
	COMMODITIES	🟡	➡	🟡	➡	🟡	➡	🟡	➡
CURRENCIES	EUR	🔴	➡	🔴	➡	🔴	➡	🔴	➡
	USD	🟡	➡	🟢	➡	🟢	➡	🟢	➡
	OTHER	🟡	➡	🔴	➡	🔴	➡	🔴	➡
EQUITIES	EUROPE	🟡	➡	🔴	➡	🔴	➡	🔴	➡
	USA	🟡	➡	🟢	➡	🟢	➡	🟢	➡
	JAPAN	🟡	➡	🟡	➡	🟡	➡	🟡	➡
	EMERGING MARKETS	🟡	➡	🟢	➡	🟢	➡	🟢	➡
BONDS	GOVERNMENT BONDS DEVELOPED	🔴	⬆	🔴	⬆	🔴	➡	🔴	➡
	CORPORATE INVESTMENT GRADE	🟢	⬇	🟢	⬇	🟡	➡	🔴	➡
	CORPORATE HIGH YIELD	🔴	⬇	🔴	⬇	🔴	➡	🔴	➡
	EMERGING MARKET DEBT	🟡	➡	🟡	➡	🟡	➡	🟡	➡
	TOTAL RETURN	🟢	➡	🟢	➡	🟡	➡	🟡	➡
COMMODITIES	OIL	🟡	➡	🟡	➡	🟡	➡	🟡	➡
	GOLD	🟡	➡	🟡	➡	🟡	➡	🟡	➡

French version

German version

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